

### CHAPTER 3

## CHINA'S PRESENCE IN THE GLOBAL CAPITAL MARKETS

**“UNITED STATES CAPITAL MARKETS.** *The Commission shall evaluate the extent of Chinese access to, and use of United States capital markets, and whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets and are also engaged in proliferation activities or other activities harmful to United States security interests.*” [P.L. 108–7, Division P, Sec. 2(c)(2)(D)]

**“CORPORATE REPORTING.** *The Commission shall assess United States trade and investment relationship with China, including the need for corporate reporting on United States investments in China.*” [P.L. 108–7, Division P, Sec. 2(c)(2)(E)]

#### KEY FINDINGS

- China is engaged in a process of selective listing of companies in U.S. capital markets. The vast majority of funds raised by Chinese firms listing in the United States—more than ninety percent—has been for state-owned enterprises (SOEs), even though the Chinese private sector accounts for roughly sixty percent of Chinese GDP.<sup>1</sup> By raising funds in the global capital markets, SOE listings increase the total value of financial resources under the Chinese government's control, since the government retains majority shareholder control, while minority shareholder rights are virtually nonexistent.
- Since May 2003, China has permitted qualified foreign institutional investors (QFIIs) to invest in its renminbi-denominated A-share market. This allows designated foreign securities firms—about half of which to date have been U.S. companies—to purchase domestic Chinese financial instruments.<sup>2</sup> Because China's capital markets are still in the early stages of development and lack transparency and a regulatory framework comparable to that of the United States, this situation raises significant governance, financial risk, and potential security-related concerns for qualified U.S. investors purchasing these equities.
- China's state-owned banks and financial institutions continue to contribute to China's economic boom through massive, politically driven lending, often based on noncommercial criteria. As a result, these institutions currently have nonperforming loans (NPLs) estimated to be approximately \$500 billion.<sup>3</sup> Since China's loan growth in the first quarter of 2004 grew by twenty-one percent over the previous year, the total NPL level will likely rise as the poor quality of these loans becomes known.<sup>4</sup> China's

WTO commitments require the country to open its financial sector to foreign competition five years after accession, or in 2006. However, due to the massive NPL problem many Chinese banks are technically insolvent and unlikely to be able to compete successfully with foreign banks. Thus, it seems unlikely that China will succeed in opening its financial sector in accordance with its WTO commitments.

- Chinese firms are not subject to accounting, transparency, and corporate governance standards consistent with U.S. norms. While the Sarbanes-Oxley Act of 2002 improved disclosure requirements for foreign issuers in the U.S. markets, U.S. investors still lack adequate information about Chinese firms and sufficient investigative mechanisms to ensure Chinese firms are meeting disclosure requirements with respect to material risks to investors. A recent Securities and Exchange Commission (SEC) probe into New York Stock Exchange (NYSE)-listed China Life's accounting irregularities and a trade secret theft and patent infringement suit brought in U.S. courts against NYSE-listed Semiconductor Manufacturing International Corp. (SMIC) underscore this problem.
- Mutual funds that invest in China—so called “China funds”—must do so on the basis of limited and often inaccurate information. It is rare for Chinese companies' financial information to be accessible to the public. As a result, China fund investors are considerably more reliant on their fund managers' due diligence than is common. This concern is compounded when large funds outsource due diligence to small-or medium-sized firms in Hong Kong, a routine practice.
- The Commission remains concerned about the nexus between Chinese firms listing on U.S. and international capital markets and weapons proliferation and China's defense-industrial complex. The U.S. government lacks adequate interagency coordination, regulatory resources, and information collection management to monitor and disclose these important relationships, which are critical to U.S. national security and may represent a material risk to investors. In addition, underwriters have not exercised appropriate vigilance in seeking out this information as part of their due diligence.

### OVERVIEW

The Chinese government has an interest in facilitating Chinese company listings on global capital markets, particularly the New York and Hong Kong stock exchanges. Such listings are predicted to generate approximately \$23 billion in 2004 alone.<sup>5</sup> China's underdeveloped domestic capital markets cannot meet the country's financial needs; thus, the Hong Kong and New York exchanges have become vital sources of capital for Chinese companies. However, China's lack of standardized and enforceable accounting and corporate governance regulations raises troubling issues from both an investor and a national security perspective.

China's legal and regulatory shortcomings present a major challenge to investors interested in purchasing a U.S.-listed Chinese stock or China-focused mutual fund, as well as analysts tasked with unraveling Chinese companies' complex web of relationships

and finances. The SEC recently announced a probe into NYSE-listed China Life's accounting irregularities, and a trade secret theft and patent infringement suit has been brought in U.S. courts against NYSE-listed SMIC. These cases appear to have cooled investors' appetite for Chinese initial public offerings (IPOs) for the moment. With an estimated \$23 billion in initial public offerings planned for 2004, however, China shows no signs of slowing the pace of listings.<sup>6</sup>

The Commission also remains concerned about the identities and activities of certain Chinese firms available for debt and equity purchases by U.S. investors and whether these firms pose security and financial risks. Questions remain regarding whether sufficient, disclosure-oriented regulations are in place to monitor this activity and whether U.S. investors are adequately informed about the true identity of Chinese companies, their senior management, and the nature of their overseas operations and parent and subsidiary relationships. Given the commingled nature of China's commercial firms and China's defense-industrial sector, it is essential for the U.S. government and U.S. investors to understand more fully the relationship between Chinese firms raising money in the global capital markets and the Chinese military and defense establishment. The NORINCO (China North Industries Corporation) case illustrates that listed Chinese companies may be involved in weapons proliferation.<sup>7</sup>

## ANALYSIS AND FINDINGS

### China's Financial and Banking Structure

China's banking sector is dominated by the country's top four commercial banks: Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), and China Construction Bank (CCB). These institutions account for some seventy-five percent of the PRC's total banking assets.<sup>8</sup> At the end of 2001, these four banks alone had 1.4 million employees and 116,000 branches.<sup>9</sup>

Four regulatory bodies govern China's financial sector. The China Securities Regulatory Commission (CSRC), which is modeled on the SEC, is the most far reaching. It formulates and oversees the policies, plans, and laws regulating securities and futures listings. The State Economic and Trade Commission (SETC), a component of the state council, organizes overall national economic plans and industrial policy and also develops the investment plan for nonmonopoly sectors of China's economy. Other government organizations involved in regulating China's financial structure are the Ministry of Finance and the People's Bank of China, the central bank of the PRC.

China's state-owned banks are beset by a nonperforming loan crisis. For decades, in an effort to maintain economic and social stability, the government encouraged banks to lend heavily to prop up failing SOEs.<sup>10</sup> In his testimony before the Commission, Professor Pieter Bottelier described this so-called policy lending and its result: "By allowing the State sector to continue expanding output and employment through easy access to State bank credit (until about 1995), China preserved full urban employment and growth

dynamics throughout the initial stages of its economic transformation, but in doing so, also created the NPL problem.”<sup>11</sup> In effect, the big four banks have been left essentially insolvent.

A comparison that helps put the scale of China’s NPL crisis in perspective is the U.S. savings and loans (S&L) crisis of the late 1980s. Following the wave of deregulation of U.S. financial markets in the early 1980s, the U.S. S&L industry embarked on a speculative lending boom that ultimately led to widespread bankruptcies and the accumulation of a massive portfolio of bad loans. To clean up this problem, Congress established the Resolution Trust Corporation (RTC) in 1989, charging it with taking over bankrupt S&Ls and selling off their assets. The total value of assets and loans taken over and sold by the RTC was \$500 billion, approximately nine percent of 1989 U.S. GDP.<sup>12</sup> As a percentage of GDP, China’s banking crisis is far larger. Goldman Sachs estimates it would cost China between forty-four and sixty-eight percent of GDP to solve the NPL crisis.<sup>13</sup> The scale of the NPL crisis in China is estimated to be approximately \$500 billion.<sup>14</sup> The value of the underlying assets supporting these loans is unknown. However, given that they have often been made on political grounds and for purposes of keeping alive loss-making companies, it is probably fairly low.

Chinese financial institutions have attempted in recent years to purge their books of NPLs through a combination of auctions, direct sales, and joint ventures. While these have often come via transfers of NPLs to China’s four asset management companies, in early 2004 state-owned banks began to sell off the assets directly. So far, China’s attempts to offload NPLs have met with mixed results. Despite Citigroup’s April 2004 purchase of NPLs with a face value of \$242 million, recently, the Chinese authorities blocked the sale of over \$520 million worth of NPLs by China Construction Bank to Morgan Stanley and forced the Bank of China to delay indefinitely a planned NPL auction valued at \$724 million. Both sales were blocked by Beijing because they came at too low a price. This suggests that in 2004 “the market for disposing of NPLs in China is in trouble.”<sup>15</sup>

Perhaps most troubling is that China continues to use non-commercially justified bank lending to promote growth and investment. Total bank lending increased dramatically in 2003 and in the first quarter of 2004 grew twenty-one percent over the previous year.<sup>16</sup> As a result of this vast new expansion of bank credit, many loans will likely end up as nonperforming and therefore risk undermining the measures that China has taken to work through its existing NPL crisis.<sup>17</sup> In short, despite China’s efforts to reduce money supply growth (e.g., selling bank bills, raising reserve requirements and placing a brief moratorium on bank lending) the politicized nature of the lending system means that banks will probably continue to generate bad loans.

With Chinese banks seeking listings on global capital markets, the implications for investors are serious. For instance, investors buying shares in the Industrial and Commercial Bank of China, China Construction Bank, or Bank of China (all of which are scheduled to list on the NYSE in the next two years<sup>18</sup>) could be

misled by restructured balance sheets and unknowingly purchase a pool of fresh loans that are likely to be uncollectible.<sup>19</sup>

Furthermore, loans that are disbursed by state-owned banks at preferential rates and without the expectation of reimbursement may constitute WTO-inconsistent government subsidies. These loans are made to Chinese exporters, and go to domestic producers who compete with foreign firms. For example, in 2003, financial institutions were required to issue loans in accordance with industrial policies.<sup>20</sup> These subsidies give Chinese companies an unfair advantage over foreign competitors and as a result appear to be inconsistent with WTO regulations.

In some cases, China is seeking to increase foreign ownership of its healthier banks. In December 2003, the China Banking Regulatory Commission granted approval to BNP Paribas (France) to purchase a fifty percent stake in the Industrial and Commercial Bank of China's joint venture bank, the International Bank of Paris and Shanghai. This bank, renamed BNP Paribas (China) Limited, is China's first foreign-owned, locally incorporated bank.<sup>21</sup> China's goal in allowing foreign investment into its banking sector is, in part, to improve the banks' financial health and lending standards.

### **PRC Corporate Governance and Accounting Standards**

China's legal framework for corporate governance is largely contained within the CSRC's Code of Corporate Governance of Listed Companies in China. In addition, the Certified Accountant Law (1993), Audit Law (1994), Company Law (1994), People's Bank of China Law (1995), Commercial Bank Law (1995), Securities Law (1998), and Accounting Law (1999) provide the framework for China's domestic capital markets.<sup>22</sup> Due to inadequate enforcement capability, regulations governing the state-company relationship are not always implemented.<sup>23</sup>

On the surface, listing shares of state-run firms in global capital markets should dilute state control and increase accountability to investors. Paradoxically, it may in fact serve only to expand the resources under state control. As explained by Professor Donald Clarke, of the University of Washington School of Law:

*China Telecom Corporation Limited (CTCL) is a shareholding limited company with shares listed on the New York and Hong Kong stock exchanges. Almost 80 percent of its stock, however, is owned by China Telecom Group Company, a traditional SOE with no shares that is directly owned by the Chinese government, while less than 12 percent of the equity was sold to the public. By creating a controlled subsidiary in the form of a shareholding company and selling a small proportion of its shares to the public, the parent SOE actually increased the value of assets under state control.*<sup>24</sup>

Chinese corporate governance standards lag far behind the United States. One problem is the state's continued control over resource allocation.<sup>25</sup> The legal framework enshrines a top-down management structure that obstructs the operation of market

forces. As a result, even if laws were properly implemented, the results would not be economically efficient.<sup>26</sup>

A second problem concerns minority shareholder rights. Cronyism, insider dealings, and rubber stamp shareholder meetings remain principal causes of investor powerlessness.<sup>27</sup> Because foreign investors are forbidden from holding a controlling interest in Chinese firms, the majority shareholder (the government, in the case of an SOE) can ignore minority investors' demands for upgraded corporate governance, transparency, and accountability.<sup>28</sup>

A third problem is the lack of a sound credit rating system. In part, this is due to poor corporate accounting practices that make it exceedingly difficult to rate Chinese companies. Another major inhibitor is the Chinese government. Companies need permission from the government before they can approach a credit rating agency, and Chinese law allows firms to keep their rating confidential.<sup>29</sup> According to Standard & Poor's, Chinese companies frequently pull out of the ratings process if they receive a bad rating. To date, credit rating agencies have given high ratings to Chinese companies based on the overall economy's impressive economic growth and the government's support of banks and SOEs.<sup>30</sup> By and large, Chinese firms' high domestic credit ratings are a reflection of implicit government guarantees rather than the health of the company or industry.

China does not follow international accounting standards. This represents a major roadblock to transparent corporate governance. For example, a 2002 survey done by CSRC revealed that one in ten listed companies had doctored its books and, in January 2004, China's Finance Ministry reported that 152 firms had misstated profits by a combined \$350 million.<sup>31</sup> PRC officials estimate that China needs three hundred thousand qualified accountants, while other independent estimates are closer to four million. To address this shortage, Beijing has opened two national accounting institutes to train accountants in international accounting methods. The Chinese government is also requiring publicly held companies to report financial data every quarter rather than every six months.<sup>32</sup>

China's state-run firms are plagued with accounting irregularities. An egregious example of inadequate disclosure was recently discovered at China Life, China's biggest insurer. The SEC is investigating an alleged \$652 million fraud,<sup>33</sup> and investigators in Hong Kong and on the mainland are looking into allegations of high-level insider dealings.<sup>34</sup> In a telling comment, indicative of the clientelist relationship between Chinese companies and the government, China's finance minister, Jin Renqing, came swiftly to China Life's defense, claiming the company had "behaved very openly" in the run-up to its IPO.<sup>35</sup> China Life issued the world's largest IPO in 2003—\$3.4 billion. Another example is SMIC, which has acknowledged that an executive had made "inaccurate statements" about the company's ability to meet expenditures through 2005.<sup>36</sup>

China is making some efforts to improve its corporate governance standards. Many small and medium-sized Chinese firms seeking to list in the United States are improving transparency and accounting practices in an effort to adhere to SEC regulations. On the domestic side, in early 2002, CSRC issued the Code of Corporate Governance of Listed Companies, which raised standards for account-

ing procedures and information disclosure. Another development came in January 2003, when China's "highest court said that shareholders could file individual or class-action lawsuits against companies that lie about their accounts."<sup>37</sup> On passage of the law, about nine hundred suits were filed (there were a total of one thousand two hundred listed companies in China at the time).<sup>38</sup>

### **China's Domestic Capital Markets**

China's domestic capital markets system was established to help meet SOEs' capital needs and thereby reduce the burden on Chinese state-owned banks to do so. Since the Chinese banking system still supplies Chinese businesses with ninety percent of their funding, Beijing also hopes this strategy will have the corollary benefit of reducing the state-owned banks' NPL problem.<sup>39</sup>

Unfortunately, providing the general public with a means of diversifying investment portfolios and hedging consumption/income risks are not among Beijing's primary reasons for encouraging its citizens to invest in its domestic capital markets.<sup>40</sup> The Chinese government often manipulates the markets to advance its political agenda. Rather than allowing capital markets to support the growth of vibrant private enterprises, China's leaders view them as a means to achieve social and industrial policy objectives and subsidize SOE restructuring, goals that are unrelated to market-based considerations. For example, Beijing is increasingly concerned about the strain on supplies of natural resources and raw materials caused by rising investment in heavy industry. To limit the development of these industries, the CSRC is attempting to prohibit firms in the steel, cement and aluminum sectors from undertaking new bond or share issues.<sup>41</sup> As a result, China's equity and bond markets lack currency convertibility, market liquidity, and an adequate range of investment instruments to guarantee moderate returns and reliable payouts.<sup>42</sup>

Three types of shares are sold on the Shanghai and Shenzhen stock exchanges. "A shares" are held by residents of China (and a select number of designated qualified foreign institutional investors). "B shares" are open to foreign investors. They are denominated in renminbi but payable in foreign currency. "C shares" are wholly owned by SOEs and are not publicly traded. In January 2004, there were 1,290 A and B share listed companies in China,<sup>43</sup> and total market capitalization in China's capital markets was \$532 billion or forty percent of GDP. This figure is expected to rise to \$850 billion (forty-seven percent of GDP) and \$1.35 trillion (sixty percent of GDP) by 2007 and 2010, respectively.<sup>44</sup> Originally, China established the B share market to boost domestic firms' access to foreign capital. However, this strategy has had only limited success. In response, China has begun to open the A share market to QFIIs.

The Chinese government has undertaken measures to improve the liquidity and transparency of its domestic capital markets. The State Council has set forth a list of reforms necessary for achieving these goals. These include strengthening institutional investors, increasing financing channels for securities companies, and attracting new sources of funds into the market.<sup>45</sup> The PRC has also recruited foreigners to help upgrade its securities market. For exam-

ple, Anthony Neoh, a former chair of the Hong Kong Securities and Futures Commission, was hired as chief advisor to the CSRC, and Laura Cha, a highly respected U.S.-trained lawyer with legal experience in both the United States and Hong Kong and former Hong Kong Securities and Futures Commission vice-chair, was hired as CSRC vice-chair.<sup>46</sup>

The Chinese government is also working to reform its domestic debt markets. The corporate bond market is currently small. Only \$3.9 billion in corporate bonds were issued in 2002. Sovereign bonds accounted for \$568 billion, compared with \$8 trillion in U.S. Treasuries. Last year, China raised \$1 billion in dollar-denominated sovereign bonds and \$500 million from a euro tranche.<sup>47</sup> While there is a demand in China for dollar-denominated corporate bonds, so far none have been issued.

To be sure, Chinese corporate governance remains a work in progress. However, the end result will not necessarily be comparable to accepted international standards. Despite reforms, China's domestic capital market system remains the domain of the SOE. Stringent listing requirements, long waiting periods, and a prohibition against restructuring during the lengthy waiting period "creates a perception and a reality to the small and medium (private) enterprises that these stock exchanges do not want them."<sup>48</sup>

### **China's Outreach to International Capital Markets: Buyer Beware**

The Chinese government facilitates and makes the decisions concerning foreign stock market listings of Chinese firms and to date has heavily favored SOEs. Although scores of Chinese firms list on the New York Stock Exchange and NASDAQ, and a handful list in London, the Hong Kong Stock Exchange has been, and likely will continue to be, the destination of choice for mainland companies seeking to raise capital in international markets. Figure 3.1 lists the IPOs for Chinese companies at home, abroad, and in the United States between 2001 and 2004.

**Figure 3.1 Home, Abroad, and U.S. Initial Public Offerings of Chinese Companies (US\$m Raised), 2001–04**

Year	A-Share	Overseas	U.S.*
2001	4,413.04	2,364.30	1,720.7
2002	5,987.21	2,497.75	1,434.2
2003	5,037.60	6,364.88	3,098.0
2004	976.56**	22,700***	N/A

\*U.S. totals are included in overseas totals.

\*\*Total as of March 17, 2004.

\*\*\*Reuters' projection for 2004.

Source: Deologic: A-Share and Overseas totals. IPO Home ([www.ipohome.com](http://www.ipohome.com))—U.S. totals.

### **Hong Kong**

There are two types of mainland Chinese company listings in the Hong Kong market: "H-shares," which are companies that are floated on the Hong Kong Exchange but incorporated in the mainland,

and “Red Chips,” which are companies incorporated and listed in Hong Kong with controlling Chinese shareholders.

Hong Kong’s capital markets have benefited from Chinese companies’ listings. In 2003, the Hong Kong Exchange ended at a two-and-a-half year high due primarily to mainland IPOs. Some of these new listings were oversubscribed by five hundred to seven hundred times. The largest were Property and Casualty Co., LTD (PICC), China Life, Great Wall Automobile, and Zijin Gold Mining. PricewaterhouseCoopers expects approximately one hundred firms (mostly from the mainland) to raise about \$12.8 billion on Hong Kong stock market listings in 2004.<sup>49</sup>

The Hong Kong Exchange has undergone important regulatory changes in recent years to improve its operations and governance standards. In March 2002, the Hong Kong Legislative Council passed a new Securities and Futures Ordinance to improve the supervision and regulation of Hong Kong’s financial markets. And in 2001, the last of the interest rate rules was abolished, “which brought to an end a government sponsored cartel in the banking industry.”<sup>50</sup> Most recently, on April 1, 2004, the Hong Kong equity market banned so-called “back-door listings.” This prevents firms from injecting assets into shell companies and skirting disclosure requirements necessary for proper corporate governance enforcement.<sup>51</sup> In an effort to beat the deadline, Chinese appliance goods giant Haier and fixed-line telecommunications company Pacific Century Cyber Works (PCCW) rushed their back-door listings to market.<sup>52</sup>

Unfortunately, Hong Kong’s stock exchange continues to operate under an apparent conflict of interest. “The same entity which operates the Hong Kong Exchange and earns fees from such listings, Hong Kong Exchanges & Clearing, also has the authority to regulate the listings, including initial listings of companies.”<sup>53</sup> This contrasts with the United States, where the SEC regulates the markets.

### ***United States***

At present there are approximately seventy Chinese companies listed on the American Stock Exchange, NASDAQ, or the NYSE, and the vast majority of funds raised by Chinese firms in the U.S. markets have gone to state-owned firms.<sup>54</sup> In March and April 2004, however, public inquiries by the SEC into the circumstances surrounding several of these listings led to some apprehension. In April 2004, Jamie Allen, secretary general of the Asian Corporate Governance Association, explained investors’ reaction: “I can’t say that over the past few months I saw investors being concerned about [the] corporate governance of the [Chinese] companies being listed. Now that the IPO rush seems to be slowing down, investors are becoming more concerned.”<sup>55</sup>

The SEC’s corporate governance and transparency requirements were strengthened in January 2002 pursuant to the Sarbanes-Oxley Act (P.L. 107–204). This act requires chief executive officers (CEOs) to certify the accuracy of their SEC filings and carries criminal penalties for inaccurate filings. “According to bankers, Sarbanes-Oxley is causing particular discontent among the Chinese CEOs. Their government is pushing for the country’s larger compa-

nies to be listed in both Hong Kong and the United States, much to the angst of those who will take charge.”<sup>56</sup> Even in cases where senior managers are not suspected of wrongdoing, they are wary of taking responsibility for accounting figures provided by others. “Sarbanes-Oxley has definitely raised the bar and it could be the reason why some Chinese corporates pull out.”<sup>57</sup>

Most Chinese firms list in the U.S. capital markets using American depositary receipts (ADRs) or as foreign filers. Companies that list using these methods are subject to less stringent SEC disclosure regulations than those that list directly or through a merger. Despite these weaker reporting requirements, some of China’s highest grossing IPOs, such as PetroChina, Ctrip, China Life, and China Unicom, have listed as ADRs. Individual investors are often unaware of the important differences in disclosure when choosing which Chinese companies’ stock to purchase.<sup>58</sup>

Some Chinese firms have gained listings in the United States through reverse mergers. “It is an active and growing strategy in China for Chinese companies to become public in the U.S. not through an IPO but by merging with an existing dormant U.S. public company and then pursuing a raise of capital through the private placement markets.”<sup>59</sup> Small—and medium—sized private Chinese firms most often use this method. There are currently thirty-one Chinese companies listed in the United States in this fashion.<sup>60</sup>

After a Chinese firm merges with a listed U.S. public company, the firm’s accounting practices become subject to SEC regulations. “Among other factors, a board of directors with independent directors and improved internal accounting procedures serve to increase the transparency of the Chinese company to the advantage of U.S. investors.”<sup>61</sup> However, an accounting and audit culture is important to any company’s development of proper corporate governance and transparency. SEC regulation enforcement requiring cooperation from local Chinese authorities also remains a concern with Chinese firms listing in this manner.<sup>62</sup>

Many U.S. investors hold Chinese equities through their mutual funds. The typical China-focused mutual fund (“China Fund”) invests sixty percent of its assets in Hong Kong stocks, with the remaining forty percent split between mainland and Taiwan firms. Some invest in other countries in the region or companies that have a presence in China.<sup>63</sup> In 2003, U.S. investors placed \$835 million into such funds, a ninefold increase over 2002.<sup>64</sup>

Because American investors are unable to access accurate and timely information about shares listed on Chinese exchanges in Hong Kong, Shenzhen, and Shanghai, they must rely on the due diligence of mutual funds. China fund investors therefore depend almost exclusively on mutual fund managers to make decisions based on on-the-ground research. More troubling is that large fund managers often enlist small, locally based firms to perform their due diligence. This is worrisome, given the questions surrounding China’s lax corporate governance and disclosure regulations. The special nature of China funds makes them particularly risky investments.

For example, a Citigroup-Smith Barney report issued on March 3, 2004, noted that the Aluminum Corporation of China Ltd.

(NYSE: ACH) “has been required to shut down 30% of production in its Guangxi Pingguo Plant due to a power shortage. We have checked with management, who deny that it is suffering power shortages, but indicate that the plant is undergoing annual maintenance.”<sup>65</sup> Thus, Chinese mutual funds should be considered a buyer-beware investment, or, as Joe Grieco, manager of financial products for Parker/Hunter, said, “It’s like buying a pack of cigarettes. We put the surgeon general’s warning on it.”<sup>66</sup>

Key recent and upcoming Chinese IPOs include the following:

- In December 2003, China Life—China’s largest insurer—launched the year’s largest IPO, valued at \$3.46 billion. In June 2003—during a restructuring ahead of China Life’s IPO—“less attractive assets” were transferred to its parent company, and China Life only retained its more desirable assets. But problems surfaced when an alleged \$652 million in irregularities resulted in a class-action suit against the company in U.S. district court. As a result, probes were launched by the SEC and Hong Kong’s Securities and Futures Commission into the company’s dealings. Anticorruption watchdogs in Hong Kong and the mainland are also investigating allegations that friends and relatives of senior China Life Insurance executives received undisclosed “preferential treatment.”<sup>67</sup>
- Semiconductor Manufacturing International Corp.—(SMIC) the largest manufacturer of semiconductor chips in China, launched a \$1.8 billion IPO on the New York and Hong Kong stock exchanges in March 2004. Despite reports that it would “see roaring investor demand,” the Shanghai-based company saw its offering fizzle.<sup>68</sup> SMIC shares fell eleven percent on the first day of trading, amid a storm of allegations. Taiwan Semiconductor Manufacturing, which had originally filed suit against SMIC on December 23, 2003, filed papers with a U.S. federal court on March 23, 2004, claiming it had new evidence, including “eyewitness accounts and technical verification,” proving SMIC had stolen aspects of its chip design.<sup>69</sup> SMIC’s offering came just a few days after the United States lodged a complaint with the WTO over tax breaks granted by the Chinese government to Chinese semiconductor firms. But perhaps most damaging was the company’s retraction of a statement by its chief financial officer that it would not need to seek external funding for capital expenditures.<sup>70</sup>
- The Bank of China (BOC), with total assets of \$440 billion in late 2002,<sup>71</sup> is reported to be preparing for an IPO in 2005. The state-owned commercial bank received \$22.5 billion in December 2003 from China’s central bank to rebuild financial reserves. The BOC has significant internal problems, including recent corruption scandals and an NPL level between twenty and fifty percent.<sup>72</sup> China’s central bank says that, as part of the IPO process, BOC will be required to come up with core business strategies by the end of April 2004 and identify annual targets for the coming years.<sup>73</sup>
- China Construction Bank (CCB), China’s third largest lending institution, is planning to make what could be a record IPO in late 2004 or 2005 worth an estimated \$5 to \$10 billion.<sup>74</sup> CCB hopes to list simultaneously on stock markets in China, Hong

Kong, and the United States. The bank, which has hired Citigroup Inc. and Morgan Stanley to lead manage the IPO, will set up a joint-stock company to own the assets it plans to list.<sup>75</sup> CCB is also faced with the task of reducing bad debts. Like the Bank of China, the Chinese government estimates that nearly one-fifth of CCB's loans are NPLs. But economists in China say a number between forty and fifty percent is more realistic. Chinese Premier Wen Jiabao recently criticized CCB managers for lack of commitment to reform and commercialization. CCB also received a cash infusion of \$22.5 billion from China's central bank to reduce its NPL ratio.<sup>76</sup>

### **Security-Related Dimensions**

During the 1980s and 1990s, China's economy was dominated by SOEs, many of which were managed by the People's Liberation Army (PLA) and were a part of China's defense-industrial complex. In 1998, in an effort to curtail corruption and return the PLA to focusing on its primary military functions, then-President Jiang Zemin called for the dissolution of this military-business structure. Divestiture served as recognition that the military should not run commercial operations.<sup>77</sup>

Because many of the former PLA enterprise heads transferred control to relatives or former military officers, the Commission remains concerned that these enterprises have retained unofficial links to their former PLA counterparts.<sup>78</sup> Moreover, the links between military and commercial production in China, particularly in SOEs, mean that foreign investors in these firms can rarely be sure of their investment's final destination. It is incumbent upon fund managers and underwriters to make investors aware of any relevant ties between China's military and companies listed in global capital markets, as such ties could be a material risk for investors.

In addition to linkages to the Chinese defense-industrial complex, the Commission continues to be concerned about the possible nexus between Chinese firms listing on U.S. and other international exchanges and weapons proliferation. The 2003 Intelligence Authorization Act (P.L. 107–306 sec. 827) included a provision that required the director of Central Intelligence to report annually on whether any Chinese or other foreign companies determined to be engaged or involved in the proliferation of weapons of mass destruction (WMD) or their delivery systems have raised, or attempted to raise, funds in the U.S. capital markets. This requirement, however, was repealed in the 2004 Intelligence Authorization Act (P.L. 108–177, sec. 361e). The Commission believes there is need for a robust, coordinated effort by the U.S. government to ensure that U.S. investors are not unwittingly investing their funds in Chinese military-related firms or weapons proliferators, and that this important issue has not been accorded a high enough priority by the intelligence community. The repealed reporting provision was a solid, positive step in this direction, and the Commission believes it should be reinstated and expanded.

As of 2002, more than three-quarters of companies listed as A shares in China's capital market are state controlled.<sup>79</sup> These include known proliferators such as NORINCO, which was sanctioned by the U.S. government on four separate occasions in 2003

for offenses including missile proliferation and sales of equipment or expertise to Iran that could be used in a “WMD or cruise or ballistic missile” program.<sup>80</sup> Under the QFII program discussed above, designated foreign financial institutions can now purchase A shares directly. This means that QFIIs, about half of which are U.S. firms (including Morgan Stanley Dean Witter, Citibank Global Markets, Morgan Chase Manhattan Bank, and Goldman Sachs), can purchase the company’s stock.<sup>81</sup> More importantly, the history of Chinese corporate nontransparency makes it difficult for investors to recognize the complex and often secretive relationships among companies, particularly with regard to state-owned entities.<sup>82</sup>

### RECOMMENDATIONS

- The Commission recommends that Congress reinstate the reporting provision of the 2003 Intelligence Authorization Act [P.L. 107–306, Sec 827] directing the director of Central Intelligence (DCI) to prepare an annual report identifying Chinese or other foreign companies determined to be engaged or involved in the proliferation of weapons of mass destruction or their delivery systems that have raised, or attempted to raise, funds in the U.S. capital markets. The Commission further recommends that Congress expand this provision to require the DCI to undertake a broader review of the security-related concerns of Chinese firms accessing, or seeking to access, the U.S. capital markets. This should include the establishment of a new interagency process of consultations and coordination among the National Security Council, the Treasury Department, the State Department, the SEC, the Federal Bureau of Investigation (FBI), and the intelligence community regarding Chinese companies listing or seeking to list in the U.S. capital markets. The aim of such an interagency process should be to improve collection management and assign a higher priority to assessing any linkages between proliferation and other security-related concerns and Chinese companies, including their parents and subsidiaries, with a presence in the U.S. capital markets.
- The Commission recommends that Congress require mutual funds to more fully disclose the specific risks of investments in China. This should include disclosure to investors of the identities of any local firms subcontracted by funds to perform due diligence on Chinese firms held in their portfolios. Subcontractors’ principal researchers, location, experience, and potential conflicts of interest should all be disclosed.
- The Commission recommends that Congress direct the Commerce Department and USTR to evaluate whether Chinese state-owned banks’ practice of noncommercial-based policy lending to state-owned and other enterprises constitutes an actionable WTO-inconsistent government subsidy and include this evaluation in the report on subsidies recommended in Chapter 1.
- In its 2002 Report, the Commission recommended that Congress prohibit debt or equity offerings in U.S. capital markets by any Chinese or foreign entity upon which the State Department has imposed sanctions for engaging in the proliferation of weapons of mass destruction or ballistic missile delivery systems. The

Commission further believes that Congress should bar U.S. institutional or private investors from making debt or equity investments, directly or indirectly, in firms identified and sanctioned by the U.S. government for weapons proliferation-related activities, whether they are listed and traded in the United States or in the Chinese or other international capital markets. For example, NORINCO, a company sanctioned by the U.S. government, is currently available for purchase on the Chinese A share market. U.S.-based qualified foreign institutional investors that have rights to trade on this exchange should not be permitted to invest in NORINCO or any other firm officially determined to have engaged in the proliferation of WMD or ballistic missiles.

**Appendix A**  
**Chinese Public Companies Listed in the United States\***

<b>Name</b>	<b>Symbol</b>	<b>U.S. Filer</b>	<b>For- eign Filer</b>	<b>For- eign Filer ADR</b>
Aluminum Corp. of China Ltd.	ACH			x
American Oriental Bioengineering, Inc.	AOBO	x		
AP Henderson Group	APHG	x		
Asiainfo Holdings, Inc.	ASIA	x		
ASAT Holdings Ltd.	ASTT			x
AXM Pharma, Inc.	AXJ	x		
Stratabid Com, Inc	BBOI	x		
Bluepoint Linux Software Corp.	BLPT	x		
Bonso Electronics International, Inc.	BNSO		x	
Beijing Yanhua Petrochemical Co.	BYH			x
China Automotive Systems, Inc.	CAAS	x		
Brilliance China Automotive Holdings Ltd.	CBA			x
China Cable & Communication, Inc.	CCCI	x		
China Eastern Airlines Corporation Ltd.	CEA			x
China National Offshore Oil Corp.	CEO			x
China Telecom Corporation Ltd	CHA			x
China Continental, Inc./UT/	CHCL	x		
Chindex International, Inc.	CHDX	x		
Chinadotcom	CHINA		x	
China Mobile Hong Kong Ltd.	CHL			x
China Resources Development, Inc.	CHRB	x		
China Unicom	CHU			x
Communication Intelligence Corp.	CICI	x		
Euro Tech Holdings Co Ltd	CLWT		x	
Ctrip.com	CTRP			x
China Wireless Communications, Inc.	CWLC	x		
China Yuchai International Ltd.	CYD			x
DF China Technology, Inc.	DFCT			x
Deswell Industries, Inc.	DSWL		x	

**Appendix A—Continued**  
**Chinese Public Companies Listed in the United States\***

<b>Name</b>	<b>Symbol</b>	<b>U.S. Filer</b>	<b>For- eign Filer</b>	<b>For- eign Filer ADR</b>
Far East Energy Corp.	FEEC	x		
Forlink Software Corp, Inc.	FRLK	x		
Graphon Corp/DE	GOJO	x		
Guangshen Railway Corporation Ltd.	GSH			x
Genesis Technology Group, Inc.	GTEC	x		
Highway Holdings Ltd.	HIHO		x	
HuaNeng Power International, Inc.	HNP			x
Harcourt Companies, Inc.	HRCT	x		
Industries International, Inc.	IDUL	x		
Intermost Corp.	IMOT	x		
INTAC International	INTN	x		
LJ International, Inc.	JADE		x	
Jilin Chemical Industrial	JCC			x
JinPan International Ltd.	JST			x
China Life Insurance Co Ltd.	LFC			x
Largo Vista Group Ltd.	LGOV	x		
Linktone Ltd.	LTON			x
Nam Tai Electronics, Inc.	NTE		x	
Netease.com, Inc.	NTES			x
New Dragon Asia Corp.	NWD	x		
Pacificnet, Inc.	PACT	x		
Peak International Ltd	PEAK	x		
PetroChina Company	PTR			x
Radica Games Ltd	RADA		x	
Sinopec Shanghai Petrochemical Co.	SHI			x
Sina Corp.	SINA	x		
Smith Investment Co.	SMIC		x	
China Petro and Chem Corp (Sinopec)	SNP			x
Sinovac Biotech Ltd.	SNVBF		x	
Sohu.com, Inc.	SOHU	x		

**Appendix A—Continued**  
**Chinese Public Companies Listed in the United States\***

Name	Symbol	U.S. Filer	For- eign Filer	For- eign Filer ADR
Tiens Biotech Group USA Inc.	TBGU	x		
TengTu International Corp.	TNTU	x		
Tom Online, Inc.	TOMO			x
UTStarcom, Inc	UTSI	x		
Webzen Inc.	WZEN		x	
Qiao Xing Universal Telephone, Inc.	XING			x
Xin Net Corp.	XNET	x		
Yi Wan Group, Inc.	YIWA	x		
Yanzhou Coal Mining Co.	YZC			x
Zi Corp.	ZICA		x	
Zindart Ltd	ZNDT			x
China Southern Airlines	ZNH			x
<b>Total</b>	<b>71</b>	<b>32</b>	<b>12</b>	<b>27</b>

\*This chart may not be exhaustive.  
Source: Halter Financial Group, Dallas, TX.

**Appendix B**  
**Expected Chinese IPO's in Global Capital Markets in 2004**  
**Total Expected IPO's ~ \$22.7 billion**

<b>Company</b>	<b>Size of Deal</b>
Semiconductor Manufacturing International Corp (SMIC)	\$1.8 billion
China Oriental Group	246.8 million
Shanghai Forte Land	220.8 million
Weichai Power Co Ltd	148.7 million
Linktone Ltd	86 million
China Green (Holdings)	28.3 million
China Construction Bank	5–10 billion*
Ping An Insurance	2 billion*
China Netcom	1.5–3 billion*
Shenhua Group	1.5 billion*
Minsheng Bank	1 billion*
Air China	500 million*
China Power	500 million*
Shenzhen Energy	500 million*
Tangshan Guofeng Steel Co Ltd	500 million*
Tencent Technology	250 million*
CSMC Technologies Corp	200 million*
Mengniu Dairy	128 million*
China Group Corp	128 million*
<b>Total completed deals</b>	<b>2.5 billion</b>
<b>Total possible upcoming IPOs</b>	<b>20.2 billion*</b>

\*Estimated  
Source: Reuters (as appeared on [www.forbes.com](http://www.forbes.com))

**Appendix C**  
**Chinese Companies' IPOs: US\$ Billions Raised in**  
**International Capital Markets, 2001–2004**



Sources: 2001–2003; Dealogic; 2004 Reuters (projection).

## ENDNOTES

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## **SECTION II**

### **REGIONAL AND GEOSTRATEGIC DEVELOPMENTS**

The following section groups topics relating to the regional and geostrategic consequences of China's emergence as a major force. These are China's economic and security impacts in Asia and the current challenges of Hong Kong and Taiwan; China's proliferation practices and the challenge of North Korea; and China's energy needs and strategies.

Chapter 4 examines China's increasing prominence in Asia. Through trade and investment, China has become increasingly interconnected with its Asian neighbors. Investors from Hong Kong, Taiwan, Japan, South Korea, and Southeast Asia are helping to fuel the export processing industries of China that, through global supply chains, deliver to the United States and Europe a wide array of manufactured goods. China's industrial growth has attracted foreign direct investment that might otherwise have gone elsewhere; some industries in Northeast and Southeast Asia have been displaced by competition from China, but Asian suppliers also have been increasingly feeding China's export processing industries and domestic markets. Large trade surpluses with China in 2002–03 have contributed to the growth of most East Asian economies.

Enhanced regional economic linkages have served China's political agenda. Through increasingly active and sophisticated bilateral and multilateral diplomacy, China is presenting itself as a country that is peacefully rising, offering, as it grows, win-win solutions for its economic partners in Asia. It has become more willing, in the past several years, to participate actively in multilateral fora on both economic and security issues—such as APEC, the ASEAN Regional Forum, and the Shanghai Cooperation Organization. Evidence indicates that this diplomatic strategy is making inroads for China, despite a wariness of China's growing military power, particularly on the part of Japan.

Cultivating relationships in Asia buys China time and space to pursue its economic development and harness its economic growth to military modernization. This is transforming the balance of military power in East Asia, particularly in the Taiwan Strait, China's main focus for a potential use of force.

Within the regional dynamic, Chapter 4 explores the difficult challenges for U.S. interests arising from China's relationships with Hong Kong and Taiwan. In these cases, China has not been offering win-win political solutions. China has positioned its military to deter Taiwan from taking political steps Beijing considers unacceptable moves toward independence and to coerce Taiwan to end the island's separate status. Clearly concerned about Taiwan President Chen Shui-bian's reelection and Chen's plan for constitu-

tional revision, China has not offered any vision for a workable resolution of cross-Strait conflict beyond unification under the “one country, two systems” formula. This formula, rejected in Taiwan, is being sorely tested in Hong Kong, where Chinese sovereignty is not disputed. China’s National People’s Congress has frustrated demands for greater democracy in Hong Kong by making unilateral decisions to block further development of constitutionally allowed self-governance, and Beijing has prohibited legislative debate on this matter in Hong Kong.

Chapter 5 looks at China’s weapons proliferation practices and its role in the North Korean nuclear crisis. While becoming enmeshed in the capitalist economies of Asia and the West, China has maintained its traditional state patron-client relationship with North Korea. China has become a major diplomatic player in the ongoing standoff with North Korea over Pyongyang’s development of nuclear weapons. As host of the Six Party Talks, China has helped bring North Korea to the table; but has not adequately employed its considerable political and economic leverage over North Korea to drive Pyongyang toward acceptance of the goal of achieving a complete, verifiable, and irreversible dismantlement of North Korea’s nuclear weapons programs.

Even as China professes to support the goal of a non-nuclear Korean Peninsula and claims to oppose WMD proliferation generally, China’s own proliferation practices remain an ongoing concern. Chinese state companies continue to pursue deals to sell WMD-related items to countries of concern to the United States. The United States has repeatedly imposed sanctions in response to these activities; but sanctions remain limited to penalizing offending companies, despite many of these companies’ direct affiliation with top levels of the PRC government or military.

Lastly, Chapter 6 examines the impact of China’s rapidly growing economy on its energy needs, the implications for global energy supplies, and how this impacts China’s geopolitical relations. China has moved past Japan to rank second (behind the United States) in global energy consumption, and is the world’s second largest oil consumer and its third largest oil importer. These trends have made China increasingly dependent on outside energy sources. China’s energy demands and the means by which it is attempting to address them have put added pressure on global petroleum supplies and prices.

Energy needs have driven China closer to the Middle East and Africa, as well as neighbors in Central Asia, Russia, and the Pacific. China seeks to lock in secure energy supplies, especially new sources of gas and oil not subject to potential disruption in a time of conflict. China has sought energy cooperation with countries of concern to the United States, including Iran and Sudan, which are inaccessible to U.S. and other western firms. Some analysts have voiced suspicions that China may have offered WMD-related transfers as a component of some of its energy deals.

Taken as a whole, China’s growing economic and political clout have important implications for its relations in Asia and beyond, with direct implications for U.S. diplomacy in Asia and for U.S. cross-Strait, nonproliferation, and energy security policies.